

**Despite Some Problems, the Internal Revenue
Service Properly Identified Returns With Rate
Reduction Credit Errors During the
2002 Filing Season**

August 2002

Reference Number: 2002-40-142

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 2, 2002

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Despite Some Problems, the Internal Revenue Service Properly Identified Returns With Rate Reduction Credit Errors During the 2002 Filing Season (Audit # 200140057)

This report presents the results of the third phase of our reviews of the advance refund provisions of H.R. 1836,¹ also known as the Economic Growth and Tax Relief Reconciliation Act of 2001. In the initial phase of our reviews, we evaluated whether the Internal Revenue Service (IRS) timely and accurately notified taxpayers about their advance refunds. In the second phase we evaluated whether advance refunds were accurately calculated and issued. The overall objective of this review was to determine if the IRS properly identified and referred for correction returns with Rate Reduction Credit (RRC) and 10 percent tax rate errors during the 2002 Filing Season.

Taxpayers were issued advance refunds, also known as rebates, during Calendar Year (CY) 2001 as required by H.R. 1836. These advance refunds were based on the taxpayers' Tax Year (TY) 2000 return information. The law also provided that eligible taxpayers who had not received the maximum advance refund may be able to claim an RRC on their TY 2001 returns. In addition, some taxpayers who were not eligible for the advance refund or the RRC could use the new 10 percent tax rate on their TY 2001 returns.

Overall, the IRS properly identified and referred for correction returns with RRC and 10 percent tax rate errors during the 2002 Filing Season. The IRS adequately prepared and implemented computer programming changes to identify RRC and 10 percent tax

¹ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

rate errors, and developed instructions for correcting these errors. However, the IRS did experience problems related to the RRC.

- The IRS experienced an unexpectedly large number of return errors related to the RRC during the 2002 Filing Season. As of April 26, 2002, with only 70 percent of the expected volume of returns processed, the IRS had already identified 6 million returns with RRC and 10 percent tax rate errors when it had planned for approximately 3 million errors for the entire filing season.
- The IRS did not increase the RRC for taxpayers who underclaimed it by small amounts because of the way IRS processes returns. The IRS informed us that it intends to identify eligible taxpayers and allow the credit that was not claimed.
- In addition to the 6 million taxpayer errors that were identified, the IRS also referred over 600,000 returns for correction even though no action was taken on over 99 percent of them. This condition was caused by a combination of the way the IRS reviews certain returns for changes that affect credits and the large volume of RRC errors.

These problems were known to the IRS prior to our discussions. However, we also identified the following two problems with the advance refund information that was added to the National Account Profile (NAP).²

- No advance refund amount was placed on the surviving secondary spouse's NAP account for a jointly filed TY 2000 return with a deceased taxpayer. If the surviving secondary spouse filed a TY 2001 return, the IRS computers could have added an RRC that the taxpayer was not entitled to receive. This could have resulted in approximately 217,000 taxpayers receiving approximately \$50 million in erroneous RRCs if these taxpayers all filed TY 2001 returns.
- Thirty-five million taxpayers who did not receive an advance refund in CY 2001 did not have a zero advance refund amount added to the NAP. These taxpayers would have received the message "we have no record of your account" if they had called the automated telephone system for advance refund information, and this would not have helped them determine if they were entitled to claim the RRC on their TY 2001 return.

We reported both of these conditions to the IRS on January 8, 2002, and the IRS promptly corrected them. These conditions were caused by a programming oversight and misinterpretation of programming requirements, respectively.

Management's Response: The IRS agreed with the outcome measures as we presented them. Management had already implemented corrective action, as noted above.

² The NAP database contains taxpayer entity information (taxpayer name and Social Security Number). This database is used to validate tax return entity information during processing.

Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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With Rate Reduction Credit Errors During the 2002 Filing Season**

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Despite Some Problems, the Internal Revenue Service Properly Identified Returns With Rate Reduction Credit Errors During the 2002 Filing Season

Background

On June 7, 2001, H.R. 1836,¹ also known as the Economic Growth and Tax Relief Reconciliation Act of 2001, was signed into law. As part of this legislation, the 15 percent tax rate was reduced to 10 percent. This legislation also provided for the issuance of an advance refund (also known as a rebate) during Calendar Year (CY) 2001 to accelerate the benefit of the new 10 percent tax rate. This advance refund was based on a taxpayer's Tax Year (TY) 2000 return information and was limited to \$600, \$500, or \$300, depending on whether the filing status on the return was married filing joint, head of household, or single, respectively.

During CY 2001, over 90 million taxpayers received the full or partial advance refund amount, totaling \$39 billion, while an estimated 35 million taxpayers did not receive an advance refund. The law provided that eligible taxpayers who did not receive the maximum advance refund amount may be able to claim a Rate Reduction Credit (RRC) on their TY 2001 returns.

The RRC would be available if the taxpayer qualified for a larger advance refund amount based on the TY 2001 return information. A worksheet was provided in the TY 2001 tax packages to calculate the amount of the credit, which would be the difference between the amount computed based on the TY 2001 return and the advance refund already received. Taxpayers who did not receive advance refunds in CY 2001 could also be eligible for the credit. The RRC is only available for TY 2001 and cannot be claimed in future years.

Taxpayers who could be claimed as dependents, or who were non-resident aliens, did not qualify for the advance refund in CY 2001 or for the RRC in TY 2001. However, based on a Congressional letter of intent, these taxpayers were allowed to claim the new 10 percent tax rate on their TY 2001 returns. For all other taxpayers, the advance refund and RRC were to be in lieu of the 10 percent tax rate for TY 2001.

¹ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

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For the 2002 Filing Season, the IRS developed programming to review each return as it was processed to verify the amount of RRC claimed. If the taxpayer claimed an incorrect credit amount, the credit was to be adjusted accordingly, resulting in a larger or smaller tax liability. The IRS was to give the RRC to eligible taxpayers who did not claim it. Similarly, the IRS reviewed returns to verify that taxpayers claiming the 10 percent tax rate were eligible to use that tax rate and to allow the rate for eligible taxpayers who did not claim it.

The IRS planned to have information available on the advance refund amounts issued to taxpayers in CY 2001 to determine taxpayer eligibility for the RRC and the correct RRC amount. To accomplish this, the IRS planned to add all advance refund amounts issued as of the end of CY 2001 to a database known as the National Account Profile (NAP).² Every taxpayer who filed a TY 2000 return was to have an amount placed on their NAP account, with joint taxpayers having the advance refund amount split between the two taxpayers. This information was also to be accessible by taxpayers, via a toll-free telephone number, to help them determine their RRC amount.

This audit was conducted at the IRS National Headquarters and the Austin, Fresno, and Memphis Campuses from October 2001 through April 2002 and in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

While Rate Reduction Credit Errors Were Properly Identified, the Large Volume of Errors Resulted in Processing Problems

Overall, the IRS properly identified and referred for correction returns with RRC and 10 percent tax rate errors during the 2002 Filing Season. The IRS adequately prepared and implemented computer programming changes to identify RRC and 10 percent tax rate errors, and developed instructions for correcting these errors. However,

² The NAP database contains taxpayer entity information (taxpayer name and Social Security Number). This database is used to validate tax return entity information during processing.

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the IRS did experience processing problems related to the RRC as the filing season progressed.

The IRS experienced an unexpectedly large number of return errors related to the RRC. The IRS planned for approximately 3 million returns with RRC and 10 percent tax rate errors during the 2002 Filing Season. However, as of April 26, 2002, with only 70 percent of the expected volume of returns processed, the IRS had already identified 6 million returns with these types of errors.

Also, not all taxpayers received the RRC they were entitled to receive because of the way the IRS processes returns. Taxpayers who underclaimed the RRC by a small amount, or who were entitled to a small RRC amount but did not claim it, did not receive that portion of the RRC. On May 8, 2002, the IRS advised us that it has plans to identify the eligible taxpayers and allow them the full credit after the filing season.

In addition to the large number of returns identified with RRC errors, the IRS also had a large increase in returns identified for manual review because of the RRC. The IRS has typically informed taxpayers of certain changes to their returns during processing that may affect credits claimed on the taxpayers' subsequent year returns, even when there is no tax change. To do this, the IRS computer selects returns meeting certain criteria for manual review by employees, most of which require no action. While this has not caused a problem in prior years due to low volumes, the large number of RRC errors during the 2002 Filing Season caused the number of returns identified for this manual review to increase by over 3,000 percent. As of late March 2002, the IRS had selected over 600,000 returns to review even though employees took no action on over 99 percent of these returns. Although the IRS was aware of this situation, only limited steps were taken to reduce the impact of this additional workload. Since the RRC is for TY 2001 only, this situation should not occur in the future.

While the IRS knew about the above-mentioned problems prior to our discussions, they were unaware of two others we identified early in our review. These problems consisted of incorrect NAP information and information that was

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The Advance Refund Amounts on the National Account Profile Were Incorrect for Some Taxpayers

missing on the NAP which affected the automated telephone service.

We analyzed the advance refund amounts that were added to the NAP at the end of CY 2001. It was particularly important that these amounts be correct because they would be used by both the IRS and taxpayers to determine the amount of RRC taxpayers could claim on their TY 2001 returns. To ensure the accuracy of RRC amounts claimed on TY 2001 returns, the IRS intended to add to the NAP the actual advance refund amounts received by all taxpayers.

However, no advance refund amount was placed on the surviving secondary spouse's NAP account for a jointly filed TY 2000 return with a deceased taxpayer. If the surviving secondary spouse filed a TY 2001 return, the IRS' computers would have erroneously indicated that the taxpayer had not received an advance refund. As a result, the computers could have added an RRC to the return that the taxpayer was not entitled to receive. We determined that a programming oversight caused this discrepancy.

We estimate that there were approximately 217,000 incorrect NAP accounts for the situation described above. If this condition had not been identified and corrected, it could have resulted in up to \$50 million in erroneous RRCs if these taxpayers all filed TY 2001 returns. We reported this condition to the IRS on January 8, 2002, and the IRS promptly made the correction to the affected accounts on January 11, 2002.

Recommendation

1. We reported this condition to the IRS for correction so the NAP would reflect the correct advance refund amounts.

Management's Response: The IRS updated the affected NAP accounts to reflect the correct advance refund amount on January 11, 2002.

Office of Audit Comment: At the request of the IRS, we conducted an analysis of our sample to determine the actual number of taxpayers affected, along with the actual dollar

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amount involved. As of July 25, 2002, we project that approximately 162,000 taxpayers actually filed a TY 2001 return and would have actually received approximately \$41 million in erroneous RRCs.

We were informed that the IRS intended for all taxpayers to have their advance refund amounts added to the NAP, including those that did not receive an advance refund. The IRS wanted all taxpayers' information added to the NAP because the IRS had modified its automated telephone system to allow taxpayers to access their advance refund information on the NAP. The IRS provided this information by telephone to help taxpayers determine if they were entitled to claim the RRC on their TY 2001 return.

However, at the beginning of the 2002 Filing Season, the IRS had not added information to the NAP for taxpayers who did not receive an advance refund. If these taxpayers had called the automated telephone system for the amount of their advance refund, they would have received the message "we have no record of your account." These taxpayers could not have completed the Rate Reduction Credit Worksheet based on the information received from the automated system. This condition resulted from a misinterpretation of the programming requirements to add the information to the NAP.

We reported this condition to the IRS on January 8, 2002. The IRS subsequently identified 35 million taxpayers that did not have this information added to the NAP database as the IRS had intended. The IRS promptly made the correction to the affected accounts as of January 15, 2002.

Recommendation

2. We reported this condition to the IRS for correction so the NAP would reflect the omitted taxpayer information.

Management's Response: The IRS added the omitted taxpayer information to the NAP as of January 15, 2002.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) properly identified and referred for correction returns with Rate Reduction Credit (RRC) and 10 percent tax rate errors during the 2002 Filing Season. This was primarily a review for computer programming problems, and it did not include the quality of the resolution of return errors that were identified by the IRS.

In order to accomplish our objective, we:

- I. Evaluated whether the IRS effectively implemented necessary changes related to processing returns with the RRC and 10 percent tax rate for the 2002 Filing Season.
 - A. Determined if the advance refund amounts on the National Account Profile (NAP)¹ were accurate and complete. We matched a statistically valid random sample of every 1,000th Tax Year (TY) 2000 return posted to the Individual Masterfile (IMF)² as of cycle³ 200139 (total sample size of 124,060 returns) to the NAP for analysis. This sample was selected from a population of approximately 124 million returns. We used this to determine if all accounts were included and if the correct advanced refund amounts were added to the masterfile.
 - B. Determined if the toll-free telephone application provided accurate advance refund information to taxpayers by making over 100 test calls (by a random judgmental sample) from January to April 2002.
 - C. Evaluated the Error Resolution System⁴ (ERS) procedures to determine if they had been updated to include instructions for processing RRC errors and if they included new Taxpayer Notice Codes⁵ for these errors.
- II. Determined if IRS computer systems accurately identified returns with RRC and 10 percent tax rate errors and referred these returns to the ERS function during processing. The samples selected for this sub-objective were taken to identify computer programming problems, and we did not plan to use them for projections.

¹ The NAP database contains taxpayer entity information (taxpayer name and Social Security Number). This database is used to validate tax return entity information during processing.

² The IRS database that maintains transactions or records of individual tax accounts.

³ A cycle is 1 week's processing at the campuses and is expressed as a six-digit code. The first four digits are the calendar year of processing. The last two digits are the processing week in that year.

⁴ The area of IRS returns processing that manually corrects return errors identified by IRS computer systems.

⁵ A Taxpayer Notice Code is used to tell the IRS processing system what error description should be printed on correction notices sent to taxpayers. There is usually a specific code for each error situation.

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- A. Evaluated whether the IRS accurately identified paper returns with RRC errors. We selected a random sample of 163 returns that were referred to the ERS for RRC errors to determine if the returns actually had an RRC error present. We also selected a random sample of 702 returns that did not go to the ERS to determine if they should have been identified as error cases.
- B. Evaluated whether the IRS accurately processed paper returns with the 10 percent tax rate. We selected an interval sample of 100 returns from those with 10 percent tax rate errors to determine if they were correctly referred to the ERS. We also selected an interval sample of 50 returns from those that appeared to meet the 10 percent tax rate error criteria but were not referred to the ERS. We then determined if the returns should have been identified as error cases.
- C. Evaluated whether the IRS accurately processed the 10 percent tax rate on United States Nonresident Alien Income Tax Returns (Form 1040NR). We selected a random sample of 46 Form 1040NR returns processed as of cycle 200212 to determine if the 10 percent tax rate was properly allowed.
- D. Evaluated whether the IRS accurately processed Electronically Filed (ELF) returns with the RRC. We selected a random sample of 300 returns with RRC errors from 2 ELF campuses to determine if these returns were properly being referred to the ERS for correction. We also identified all ELF reject codes⁶ associated with RRC errors and used IRS reports to determine whether returns with these conditions were being rejected.

⁶ Reject codes are used to inform electronic return filers of errors that caused their ELF returns to be rejected.

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Appendix II

Major Contributors to This Report

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)

Stanley Rinehart, Director

Richard Calderon, Audit Manager

John Kirschner, Senior Auditor

Cari Fogle Robben, Auditor

Steven Stephens, Auditor

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner N: DC
Senior Advisor to the Office of the Commissioner N: DC
Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Wage and Investment Division W
Director, Strategy and Finance W:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
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 Chief, Customer Liaison S:COM
 Commissioner, Wage and Investment Division W

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 217,000 taxpayers had incorrect advance refund information on their National Account Profile (NAP)¹ accounts, which could have resulted in approximately \$50 million in erroneous Rate Reduction Credits (RRC) on Tax Year (TY) 2001 returns (see page 4).

Methodology Used to Measure the Reported Benefit:

We obtained from our Office of Information Technology a random sample of every 1,000th account with a TY 2000 return posted to the Internal Revenue Service (IRS) Individual Masterfile² as of cycle 200139. We matched this sample against the data on the NAP database to determine the accuracy of the NAP. We identified 217 joint accounts with a deceased taxpayer that did not contain the correct advance refund amount, equating to 217,000 affected accounts. The average joint advance refund amount for the 217 accounts was \$470, or \$235 per taxpayer. Using this information, we estimate there was a potential for erroneous RRCs of approximately \$50 million, depending on how many of the affected taxpayers filed a TY 2001 return.

Office of Audit Comment: At the request of the IRS, we analyzed the 217 accounts to verify how many taxpayers did file a TY 2001 return and would have received erroneous RRCs. As of July 25, 2002, we determined that 162 of the 217 accounts did file a TY 2001 return. Projecting that to the population, approximately 162,000 taxpayers actually filed a TY 2001 return and would have actually received approximately \$41 million in erroneous RRCs.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 35 million taxpayers did not have advance refund information available on the IRS automated telephone system to help them determine if they were entitled to claim the RRC on their TY 2001 returns (see page 5).

¹ The NAP database contains taxpayer entity information (taxpayer name and Social Security Number). This database is used to validate tax return entity information during processing.

² The IRS database that maintains transactions or records of individual tax accounts.

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Methodology Used to Measure the Reported Benefit:

The number of advance refund records initially added to the NAP did not match the overall number of taxpayers who filed a return in TY 2000. The missing records were for taxpayers who did not receive advance refunds in 2001. After the IRS corrected this condition, it reported that it had added approximately 35 million records to the NAP, which equates to 35 million affected taxpayers. This number approximates the number of taxpayers reported as having not received an advance refund.

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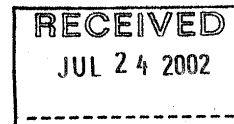
Appendix V

Management's Response to the Draft Report

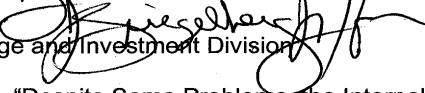


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

July 23, 2002



MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM: John M. Dalrymple 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – "Despite Some Problems, the Internal
Revenue Service Properly Identified Returns With Rate
Reduction Credit Errors During the 2002 Filing Season (Audit
#200140057)

I was pleased that your audit found that our implementation of the advance refund provision of the Economic Growth and Tax Relief Act was very successful. You also noted that when we identified problems from internal or external sources, we were able to address them effectively.

As you acknowledged in your report, "Overall, the IRS properly identified and referred for correction returns with RRC and 10 percent tax rate errors during the 2002 Filing Season. The IRS adequately prepared and implemented computer programming changes to identify RRC and 10 percent tax rate errors, and developed instructions for correcting these errors."

The report is an accurate presentation of management's actions. Because of your staff's prompt notification, we were able to take timely corrective actions to avert possible erroneous Rate Reduction Credits (RRCs), and provide more accurate information to customers using our automated telephone service. I appreciate the oversight and assistance provided by your staff. I agree with the potential outcome measures you identified in your report.

If you have any questions, please call me or Ronny Rhodes, Director, Customer Account Services, at (404) 338-8910.